What Monthly Payment Gets You in this Car? Payment/Interest Bias and The Market for Consumer Loans

Victor Stango and Jonathan Zinman*

PRELIMINARY DRAFT: PLEASE DO NOT QUOTE

Abstract

Many lenders market consumer loans by advertising low monthly payments rather than interest rates. In this paper, we provide an explanation for such behavior motivated by the fact that many consumers display what we call "payment/interest bias:" a systematic tendency to underestimate the annual percentage rate (APR) associated with a loan principal and payment stream. Using data that quantifies payment/interest bias and also contains detailed information on the actual loans held by consumers, we examine the relationship between loan rates, bias and loan sources. We find that households with bias hold loans with higher interest rates, but only on loans obtained from finance companies; there is no such relationship for loans from banks. The relationship holds not only across households, but within households who hold loans from both banks and finance companies. It is robust to the inclusion of a rich set of household- and loan-specific characteristics. The findings are consistent with the emerging view [Ellison (2005), Glaeser (2004)] that firms may provide frames that cater to cognitive biases in equilibrium. More directly, our results provide a positive explanation for the ubiquity of loan marketing emphasizing low monthly payments, particularly by finance companies.

---

* *Stango:* Associate Professor of Business Administration, Tuck School of Business, Dartmouth College, Hanover NH 03755. *Email:* victor.stango@dartmouth.edu. *Zinman*: Assistant Professor of Economics, Dartmouth College, Hanover NH 03755. *Email:* jonathan.zinman@dartmouth.edu. Andrew Bernard, Doug Staiger and seminar participants at The Federal Reserve Board of Governors, Dartmouth, the Federal Reserve Banks of Chicago, Philadelphia and Boston and the Federal Trade Commission provided helpful comments. Thanks to Bob Avery and Arthur Kennickell for particularly useful discussions regarding the Survey of Consumer Finances. Special thanks to Jesse Leary for pointing us toward relevant FTC actions.